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SUBJECT: CENTRAL BANK OF YEMEN USING "MORAL PERSUASION" FOR ENFORCEMENT

11. (SBU) Summary: During a MEPI-sponsored assessment of the Yemen banking system, representatives of the Financial Services Volunteer Corps engaged in lengthy discussions with Central Bank of Yemen (CBY) Sub-Governor for Control Abdullah Ulaifi and Payment Systems Director Omar Bazara. Both officials gave candid assessments of the weaknesses of the Yemeni banking system: Prevalent insider lending, over-use of short-term loans, limited CBY oversight authority and capacity, and intervention of the Ministry of Finance in CBY regulatory policy. End Summary.

Commercial Banking: Short-term loans for "trade finance"

12. (SBU) According to Ulaifi, Yemen's fourteen commercial banks, four of which are Islamic, lend about one-third of their capital to "trade-finance" projects with terms under one year. Ulaifi claimed commercial lending is on the rise and that the liquidity of Yemen's banks is not a problem since the commercial banks are heavily invested in Treasury Bills. Ulaifi said that deposits are increasing 25 percent a year due to point-of-sale purchases. Most of the banking sector, however, contends that lending remains stagnant because of a lack of legal enforcement against defaulters and the absence of a reliable credit rating system. (Note: only three percent of Yemenis hold bank accounts. End Note). Ulaifi said that Islamic banks are the fastest growing sector of the market.

13. (SBU) The banking law requires Yemeni banks to have a minimum capital adequacy ratio of 8 percent, and the Central Bank requires ten percent of bank liquidity to be held in Yemeni Riyals (YR) and twenty percent in foreign currency. Existing capital requirements are 6 billion Riyals, roughly 2 million USD.

CBY Enforcement: "Moral Persuasion"

14. (SBU) The Central Bank has seventeen bank examiners located at the bank to do monthly on site inspections. Ulaifi affirmed that insider lending, with banks lending to their own boards of directors and close associates, is the biggest problem facing the banking system. Ulaifi said the CBY uses "moral persuasion" to reduce these practices, complaining that the CBY's oversight powers as defined in the banking law, were watered down due to the influence of powerful Yemeni banking families. (Comment: Most of Yemen's banks are essentially vaults for the major families and their business associates to place their money, they are by and large reluctant to lend to anyone unknown to them. End comment).

15. (SBU) The CBY uses the Capital, Assets, Management, Earnings and Liquidity (CAMEL) system to rank their banks from 1 (best) to 5 (worst). Ulaifi admitted that two banks in Yemen ranked a five and one a 4. (Note: One FSVC volunteer said that these three banks should be shut down. End note.) Ulaifi said 85 percent of banks in Yemen rank at one or two on the scale. If a bank scores a five the CBY prohibits it from distributing profits or opening new accounts or branches. Ulaifi characterized the two poorly performing banks as suffering from non-performing loans, low capital and bad management.

16. (SBU) The CBY does not have an arbitration office, and maintains only a limited credit bureau. The CBY revoked one bank's license for issuing bad loans after several depositors were unable to withdraw their deposits. Because they exceeded the bank's capital, the ROYG took over these loans. Complicating the situation Yemen's weak commercial courts are unable to enforce claims on collateral. Without strong commercial courts, Ulaifi asserted, insider trading is encouraged and banks are reluctant to expand business.

T-Bills crowding out Loans?

17. (SBU) Ulaifi discussed IMF concern that the CBY is over reliant on Treasury Bills and therefore crowding out other

investments. Ulafi contended that this is not a problem and that T-Bills are a low risk option for banks. (Note: Ulafi may be correct, but as liquidity is not an issue for most banks they should have sufficient funds for both T-Bill and other investments. End note). T-bills are sold at 3 month, 6 month and 1 year increments. This year the CBY sold 500 Million YR in T-Bills as opposed to last year,s sales of 700 million YR. Ulafi said that Yemen's monetary policy applies indirect measures to maintain monetary stability and to forecast liquidity in an effort to bring inflation down. The Central Bank Law mandates that inflation control and exchange rate stability are the two priorities of Yemen's monetary policy. It accomplishes this by selling T-Bills to reduce the money supply and by selling foreign currency. Due to negligible borrowing in Yemen, the CBY cannot regulate monetary policy by raising or lowering interest rates.

18. (SBU) Omar Bazara, Payments Systems Director for CBY, noted that T-Bills are often used by commercial banks when balance sheets show an end-of-the-day deficit. Rather than disclose their financial status to competitors in order to receive bridge loans (a normal practice in healthy banking systems), banks sell back T-Bills to the CBY. Members of FSVC pointed out that a strong central bank would discourage this practice, which should not be one of its core functions. The CBY purchases T-Bills at near market price, however, so there is little incentive for the banks to change this practice.

Draft Banking Law to Strengthen Central Bank

19. (SBU) Ulafi was optimistic the draft banking law (when passed) would give the CBY new powers to remove incompetent bank management, even at private banks. Ulafi said that the World Bank had advised the CBY and Ministry of Finance to create a new law focusing on non-performing loans and low-capitalization and offered to assist in its drafting. Ulafi said that while the CBY is independent according to the 1998 banking law, in practice the powerful Minister of Finance regularly interferes with monetary policies.

Comment

19. (SBU) The CBY's authority is constrained by the interference of the Ministry of Finance and by its role as a commercial bank for government employees. FSVC volunteers recommend that the Central Bank cease functioning as a commercial bank and focus instead on oversight and management of Yemen,s poorly performing banking sector. Unfortunately, the CBY, under the thumb of the Minister of Finance, seems to be moving in the opposite direction. The ROYG has moved the direct deposit of public salaries from commercial banks back to the CBY, where they are paid in cash. This perpetuates Yemen's cash economy and maintains MOF's control over payroll (which is often abused). The CBY is even considering installing its own ATM machines. MOF is also looking to expand its reach into the insurance and accounting sectors. These actions increase MOF's involvement with the CBY and serve to weaken its focus on performing core functions. End Comment.
KHOURY